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The attached briefing package was requested by the NIO/Europe
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Attached:

CEMA-EC Update--EURM86-20071

EC-CEMA: Improving Prospects for a New Relationship (European Review)

USSR-Eastern Europe: New CEMA S&T Program (IEEW Article)

Soviet-East European Trade Plans for 1986-90 (USSR Review)

8 May 1986

CEMA-EC Update

- The most significant recent development is a 17 April letter from CEMA Secretary General Sychev in response to the EC letter of 30 January.
- The Sychev letter officially confirmed CEMA's acceptance of bilateral ties between its members and the EC.
- The EC Commission planned to discuss the Sychev letter on 5 May, but will not respond to it until receipt of replies from individual CEMA countries, which are expected soon.
- Sychev proposed that the first expert-level meeting be held in June, but EC prefers next fall.
- Several unresolved issues suggest that progress will be slow.
- The level and type of CEMA representation to the EC has been left ambiguous.
- Economic interests in several EC countries will continue to oppose increased access to EC markets for East European agricultural and other products.
- The EC remains wary that Moscow will push the EC-CEMA relationship at the expense of bilateral ties.
- The FRG is pressing for a Berlin clause to be included in any CEMA-EC agreement.
- The EC may want to exclude non-European CEMA countries--Cuba and Vietnam.

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Articles

**EC-CEMA: Improving Prospects
for a New Relationship**

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The EC Commission has informed CEMA that the Community stands ready to resume discussions on establishing formal ties between the two economic blocs. The negotiations, expected to begin this year, almost certainly will focus on political rather than economic relations. The Community traditionally has preferred conducting business with East European states bilaterally and undoubtedly will reject any bloc-to-bloc agreement with CEMA that precludes such contacts. Nevertheless, the 12 EC members believe recent overtures from Moscow signal a softening in Soviet antipathy toward the Community and are unlikely to torpedo establishing a political framework for future economic contacts with CEMA and its members. []

Overcoming Old Problems

Discussions between the two economic organizations were suspended in 1981 after six years of negotiations failed to overcome two difficulties. First, the EC maintained that fundamental differences between the two organizations—especially the absence of an integrated CEMA customs area, a common commercial policy, and a legally competent secretariat—limited the scope of any potential CEMA-wide trade agreement. The Community, therefore, rejected Moscow's proposal for establishing a joint committee to oversee bilateral trade and economic relations between the EC and individual CEMA states. Second, the Soviets refused to officially recognize the EC and the Commission's authority—a key demand of EC members—and, as a result, rejected EC attempts to expand bilateral ties to East European states. []

CEMA failed to respond in 1981 to a formal request from EC Vice President Hafferkamp for its views on how to overcome these differences. The general

worsening of East-West relations in the early 1980s, the continued Soviet presence in Afghanistan, the East European debt crisis, and the declaration of martial law in Poland shattered what little prospects remained for continuing the negotiations. []

Despite Soviet hints of renewed interest in EC-CEMA talks in 1984, EC members were caught off guard in May 1985 when General Secretary Gorbachev expressed interest in renewing EC-CEMA contacts to visiting Italian Prime Minister Craxi. Moscow's apparent change of heart was confirmed a month later by a formal letter from CEMA to EC Commission President Delors requesting that discussions be resumed, and in September 1985 CEMA proposed establishing political ties between the two organizations as a first step toward "normalizing" relations. A major obstacle was also overcome when Moscow, as a result of EC efforts, reportedly dropped its objections to EC bilateral relations with CEMA countries. Last month the EC requested the views of individual CEMA members on establishing bilateral relations before committing itself to discussing a broader agreement with CEMA. []

Next Steps

We believe Community members view establishing a political framework with CEMA as basically a no-lose proposition and are committed to pursuing formal EC relations with East European states. Nevertheless, EC members almost certainly remain wary of Moscow's motives in pursuing an EC-CEMA agreement at this time and are likely to proceed slowly and carefully with the discussions. The US Mission to the EC believes the Community is stringing out further negotiations by requiring individual CEMA members to give their views on establishing formal relations before officially replying to CEMA. []

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The EC's foremost fear undoubtedly is that Moscow will use an EC-CEMA agreement as a tool to enhance its control over the foreign economic relations of East European states. [redacted]

[redacted] According to diplomatic reports, Hungarian officials told West German Foreign Minister Genscher that a detailed EC-CEMA agreement could strangle Hungary's economic ties to the West. We believe Moscow probably also is pressuring East European states to suspend any discussion of establishing economic relations with the EC until after an umbrella EC-CEMA agreement is signed. [redacted]

EC members are well aware of the possibility that Moscow may view an EC-CEMA agreement as a potential wedge to divide the West, and we believe most EC members recognize that the Soviet Union is pursuing an EC-CEMA agreement, at least in part, for propaganda purposes. According to diplomatic reports, the EC Commission official responsible for negotiations with Eastern Europe believes that Moscow primarily is seeking to establish an international role for CEMA on a par with other international organizations. Moscow, for example, already has begun to seek office space in Brussels for a CEMA delegation. The Commission official notes, however, that neither CEMA nor the Soviet Union has addressed the political or economic aspects of improved EC-CEMA relations, and he believes CEMA will give short shrift to more substantive EC-CEMA discussions. [redacted]

The Community is considering limited steps in the foreign policy area to ensure that the prospects of an EC-CEMA accord stay on track. In addition to requesting the views of individual East European capitals on an agreement, the EC-12 are considering sponsoring biannual luncheons in Moscow to keep ranking Soviet officials informed of EC policies. Moreover, the embassy of the EC presidency

country—which rotates among members every six months—probably will be given additional responsibilities to convey EC declarations and policies in East Bloc capitals. EC officials, however, will not consider more formal exchanges on foreign policy issues until after EC-CEMA relations are officially established, according to a diplomatic report. [redacted]

Economic Stakes

EC officials do not expect any great surge in EC-CEMA trade as a result of an overarching agreement, but over time expanded relations with CEMA and its individual members should improve trade prospects, particularly in agriculture. European Community trade with the Soviet Union and Eastern Europe is not insignificant; in 1984 the Soviet Union and Eastern Europe accounted for almost 7 percent of extra EC exports and about 10 percent of extra EC imports.¹ EC sales to the East Bloc²—predominantly manufactured goods—rose nearly 30 percent from 1980 to 1984. During the same period, however, EC imports from the Soviet Union and Eastern Europe nearly doubled in value—from about 22 billion ECU to nearly 40 billion ECU (roughly \$17 billion and \$30 billion, respectively, at 1984 exchange rates) primarily because of increased energy imports from the Soviet Union. The Soviet Union remains the EC's fourth-largest trading partner; the value of Soviet trade is roughly one-quarter that of EC trade with the United States. West Germany accounts for about two-fifths of all EC trade with the Soviet Union and Eastern Europe, while France and Italy together are responsible for one-third. [redacted]

East Bloc exports to Western Europe—with the exception of energy—have remained relatively stagnant since 1980 and the inability of East European states to expand sales to the West has dampened the prospects for increased East-West trade. [redacted]

CEMA generally no longer can compete against Third World producers in the West European market.

¹ EC trade figures do not include Spain and Portugal, which joined the Community early this year. [redacted]

² East Bloc in this article refers to the Soviet Union plus Poland, East Germany, Czechoslovakia, Hungary, Romania, and Bulgaria. [redacted]

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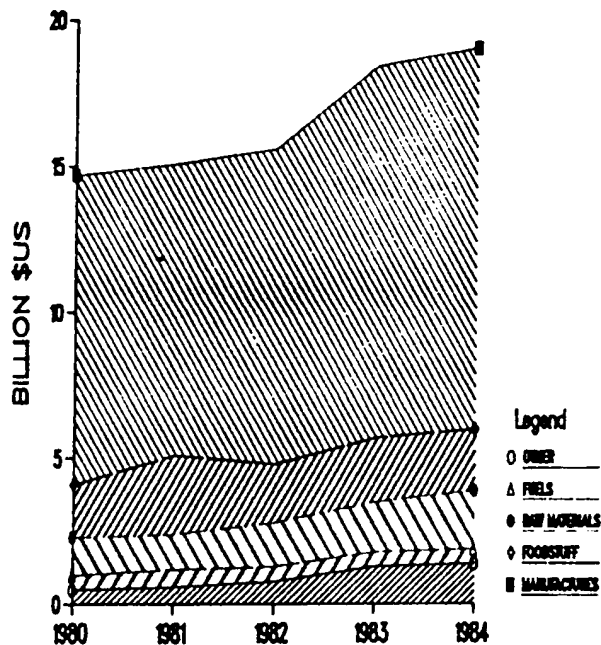
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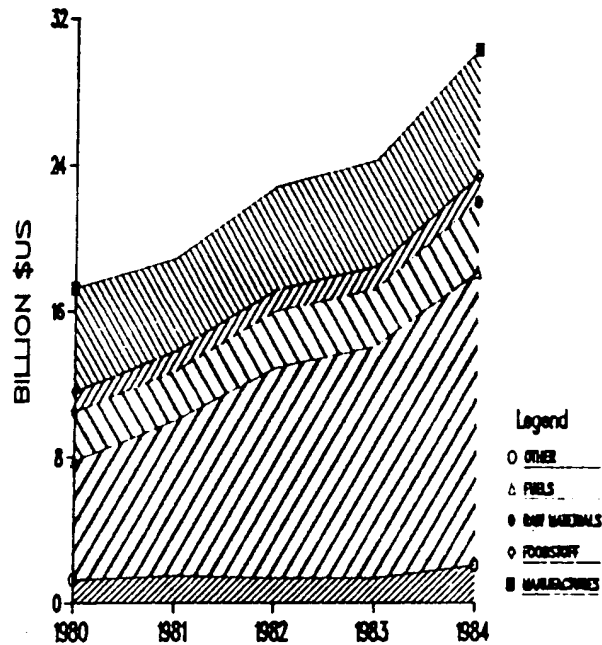
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Figure 1

EC commodity exports to East Bloc*



EC commodity imports from East Bloc*



* ECUs converted to dollars using the average 1984 exchange rate: 1.27 ECU = \$ 1 US

Furthermore, overcapacity in many West European industries—chemicals, petroleum refining, automobiles, and agriculture, to name a few—will continue to hamstring Soviet and East European strategies to increase exports to the West. [REDACTED]

According to diplomatic reports, EC officials generally do not expect to significantly expand exports to the East Bloc—except possibly in grains, butter, and meat—through the end of the decade and therefore discount the economic benefits of an accord with CEMA. [REDACTED]

projections for continued high rates of unemployment in Western Europe almost certainly will sustain interest in even minimal sales of manufactures to Eastern Europe. [REDACTED]

EC's Longer Term Objectives

Despite relatively dim prospects for expanding economic relations with Eastern Europe, EC officials see political payoffs in CEMA's proposal for

establishing formal ties to the Community. According to diplomatic reports, they contend a broadly worded EC-CEMA agreement could facilitate negotiating bilateral agreements with individual East European states and that Moscow has given the green light to this approach. To date, maverick Romania is the only East Bloc country to have concluded a bilateral economic agreement with the EC. [REDACTED]

According to diplomatic reports, the EC Commission believes its recent discussions with Hungary—although stalemated over the terms of access to the EC market—attest to the Community's desire to expand bilateral relations with individual East European countries. Czechoslovakia and Poland also have expressed interest in concluding bilateral trade agreements. Only East Germany—which enjoys greater, but limited, access to the EC market through its special trade relationship with West Germany—and the Soviet Union remain uninterested in an economic agreement with the Community. [REDACTED]

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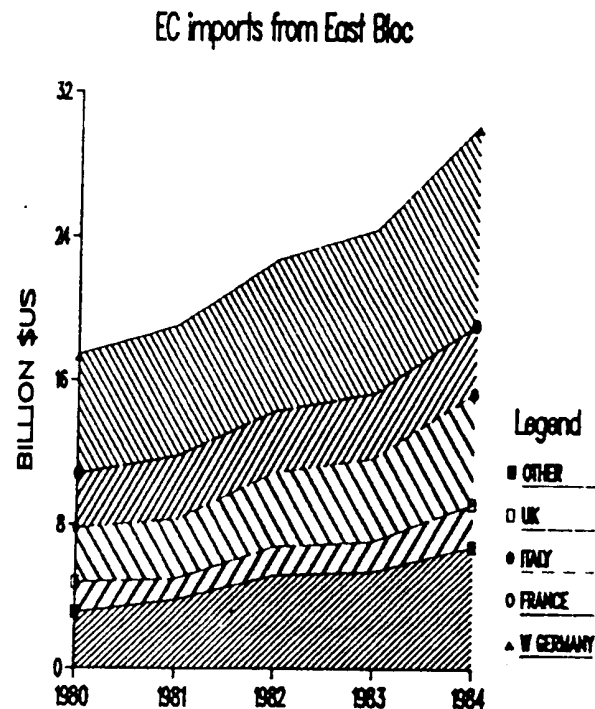
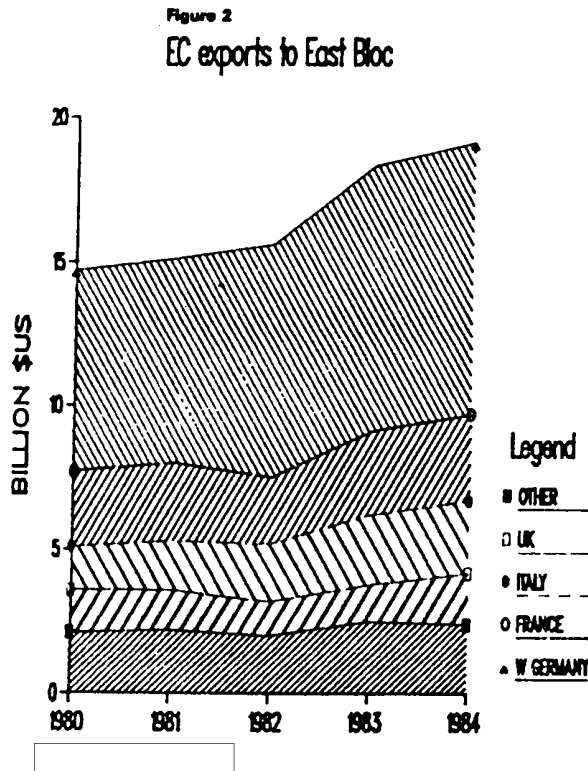
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EC members apparently believe that an EC-CEMA political statement would confirm and contribute to the general warming in East-West relations as well as the Bloc's official recognition of the EC. According to diplomatic reports, an EC Commission official believes EC members generally are looking for "detentiste" gestures. The EC clearly placed a future accord with CEMA in this broader context by postponing its reply to CEMA's proposal for formal relations until after the Geneva summit last

November. We believe EC members remain uncertain over the course of future relations with the Soviet Union, but they undoubtedly see the opening by CEMA as an opportunity to develop wider, more active relations with East European states.

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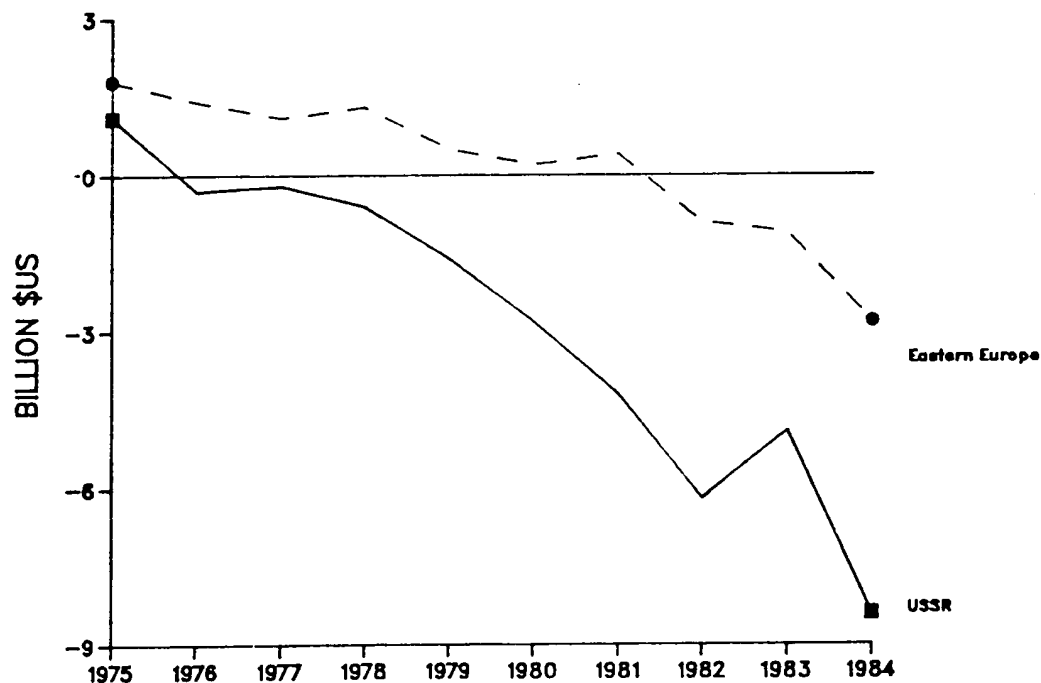
The development of an EC-CEMA dialogue also would provide West European countries, as a group, with a forum to discuss East-West relations

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Figure 3

European Community: Trade Balance With USSR And Eastern Europe, 1975-1984



independent of NATO. We believe a future EC-CEMA agreement probably will parallel the EC's already negotiated, broadly worded, political framework agreements with ASEAN and the Central American states that cite the desirability of improved

relations and establish regular meetings of foreign ministers.

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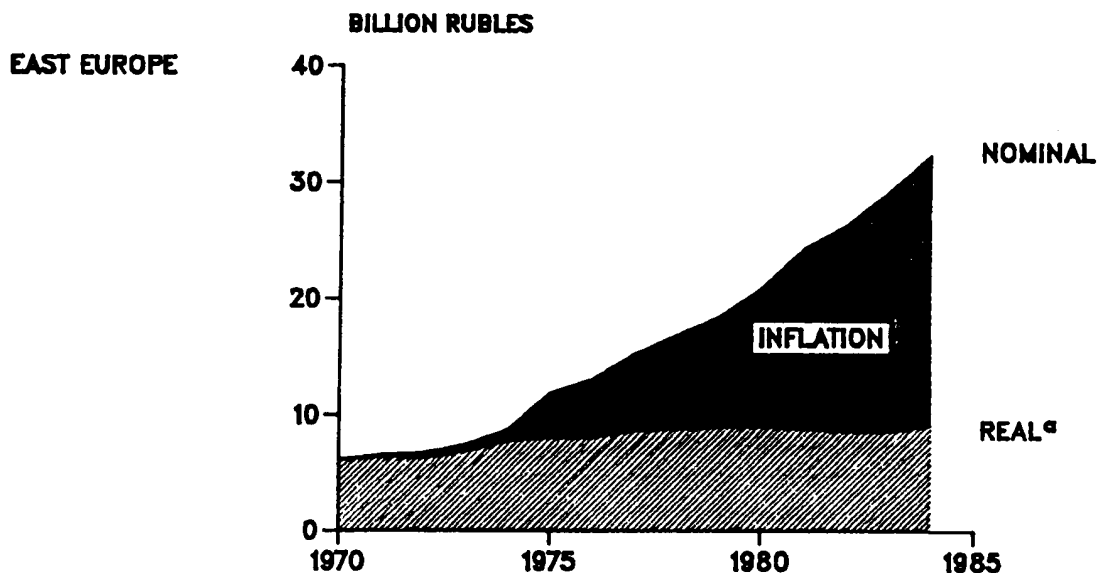
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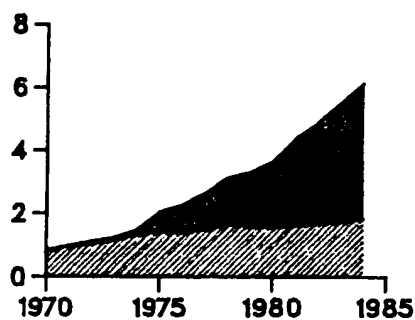
Trade Trends

- In value terms, Eastern Europe appears to have shifted its trade from the West to the USSR in recent years.
- The Soviet share of the value of Eastern Europe's trade increased from 37 percent in 1981 to 39 percent in 1984, while the West's share fell from 35 percent to 28 percent.
- This reorientation of trade is often cited as evidence of the USSR's efforts to pull Eastern Europe away from the West economically.
- Our estimates, however, show that in terms of the actual flows of goods, there has not been a reorientation toward Moscow in the 1980s.
- The Soviet share of the value of Eastern Europe's trade has risen largely because of steeper inflation in intra-CEMA trade.
- East European trade in recent years has shown remarkably similar paths in real trade with both the West and the USSR--stagnant imports and expanding exports.
- The East European countries have responded to Moscow's call for a more balanced economic relationship.
- Exports to the USSR have grown rapidly while Moscow has held the line on deliveries of oil and other raw materials.
- Eastern Europe's trade deficit has fallen from a peak of 3.1 billion rubles in 1981 to 1.1 billion rubles in 1985.
- Poland accounted for almost all of the 1985 deficit--the other five countries nearly balanced trade with the USSR.
- The Soviet oil price subsidy to Eastern Europe vanished last year, and the fall in OPEC prices this year means that Eastern Europe is paying Moscow double the price of Western oil.

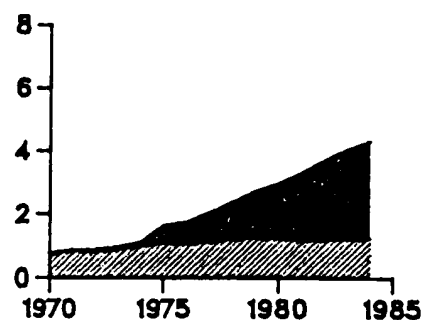
EAST EUROPEAN IMPORTS FROM THE USSR



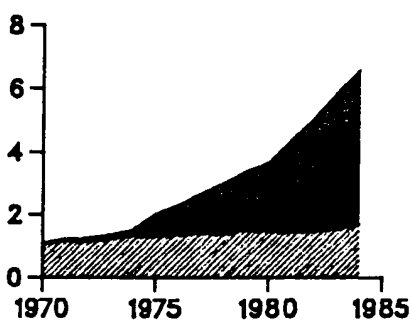
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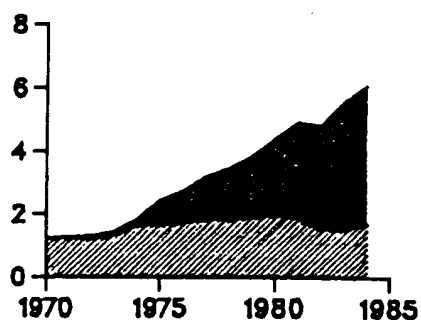
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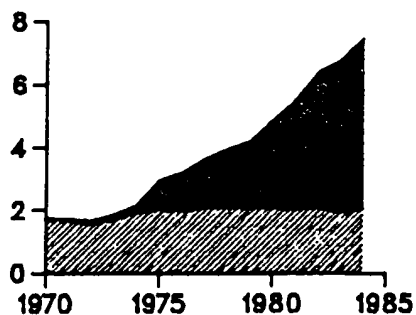
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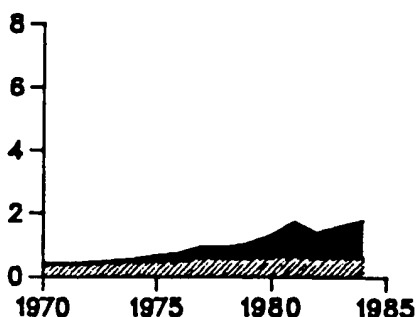
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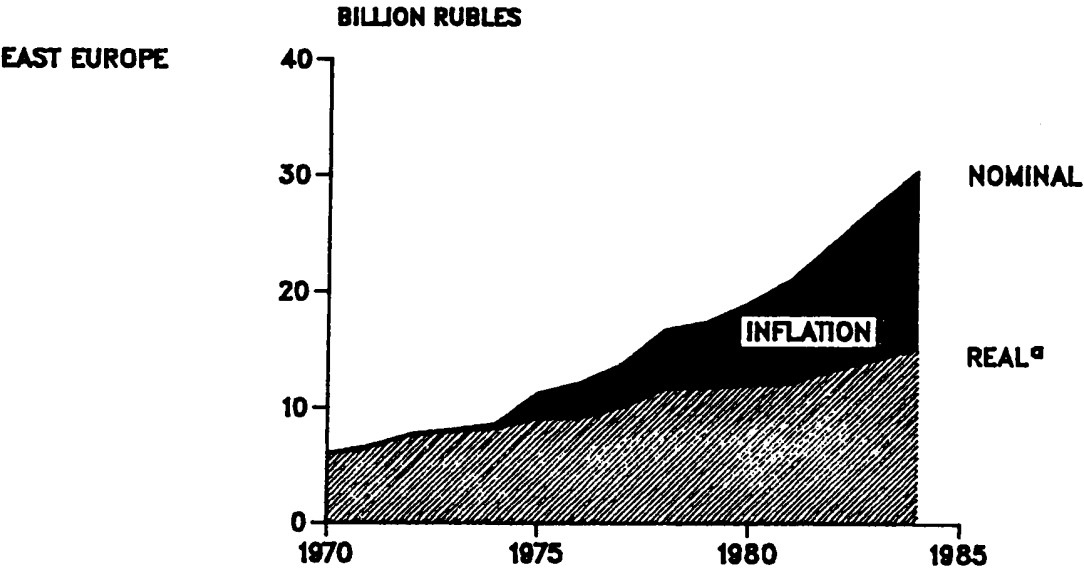
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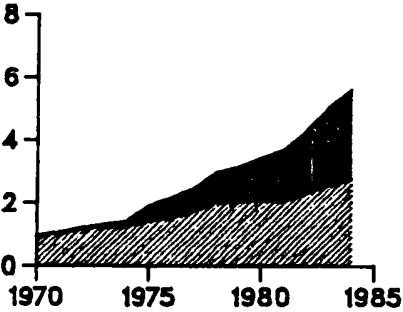
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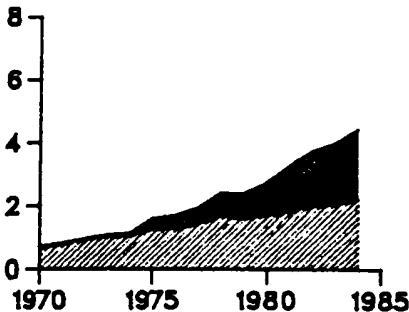
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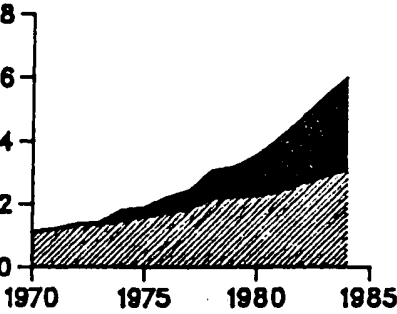
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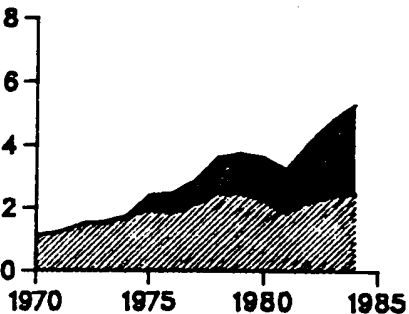
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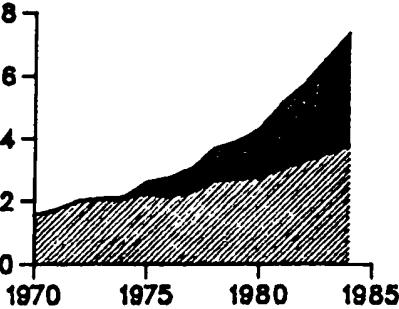
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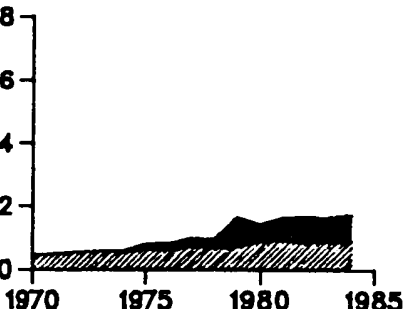
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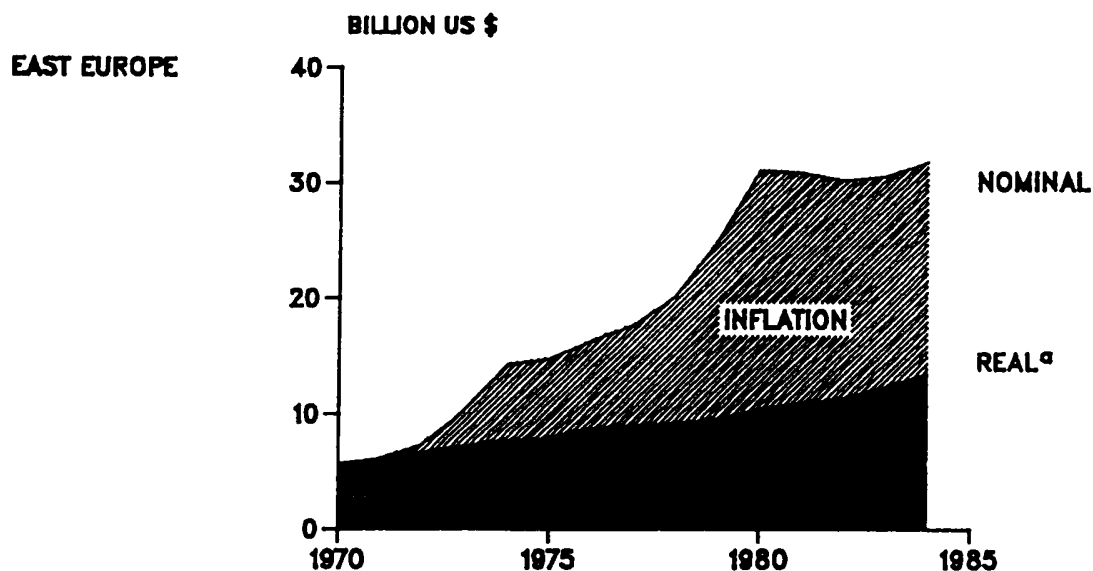
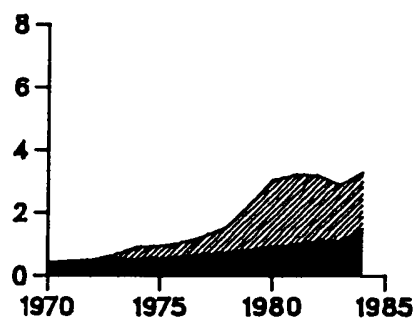
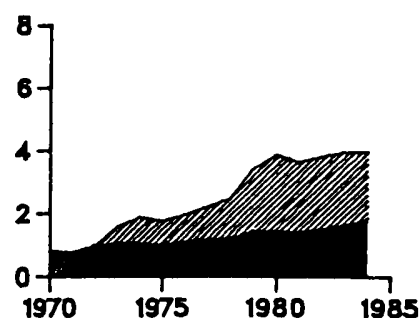
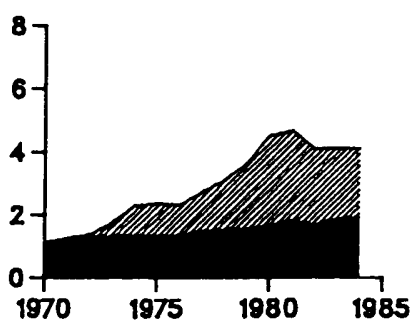
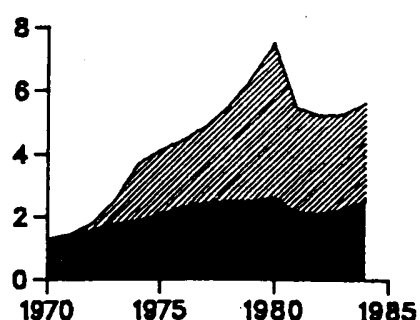
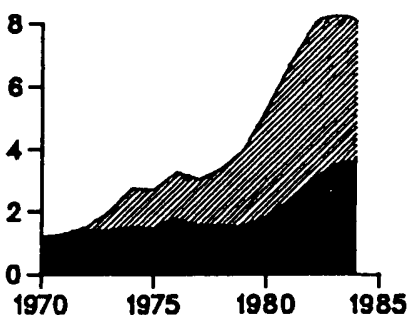
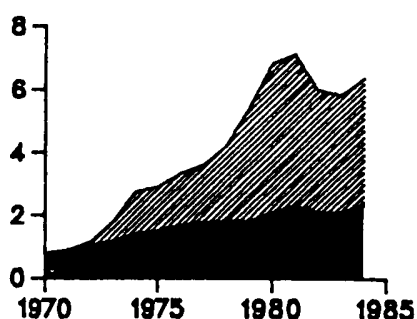
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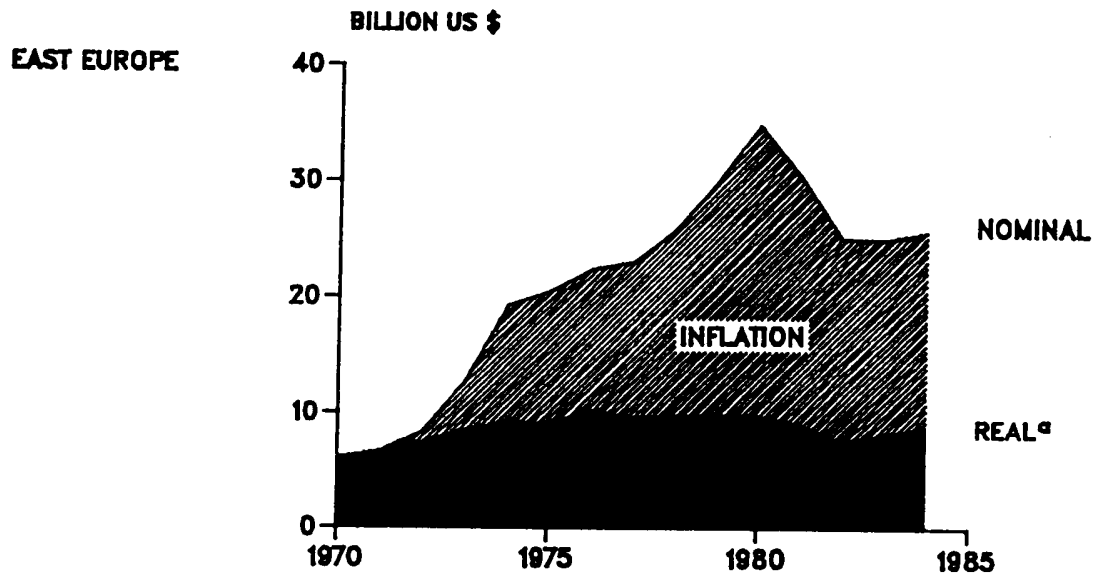
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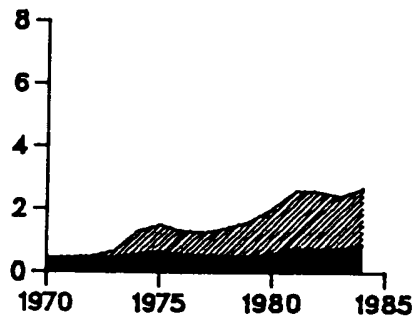
EAST EUROPEAN EXPORTS TO NONSOCIALIST COUNTRIES

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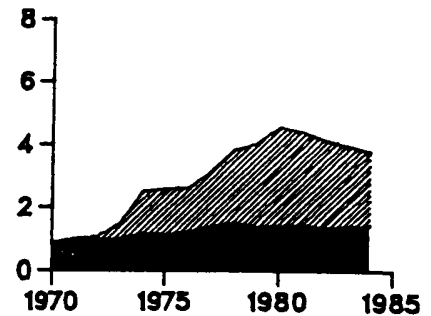
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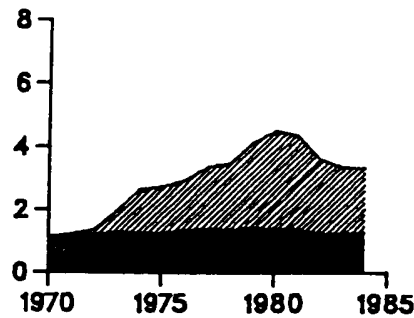
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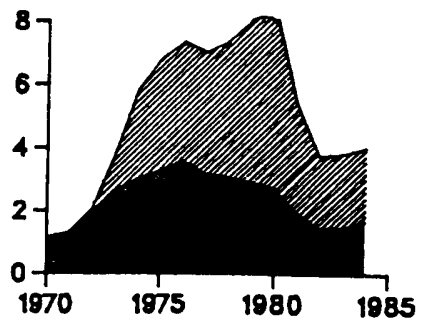
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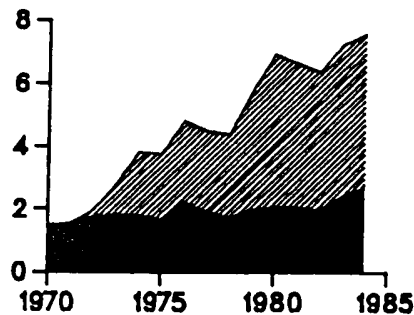
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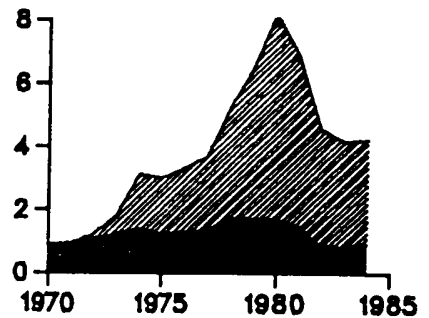
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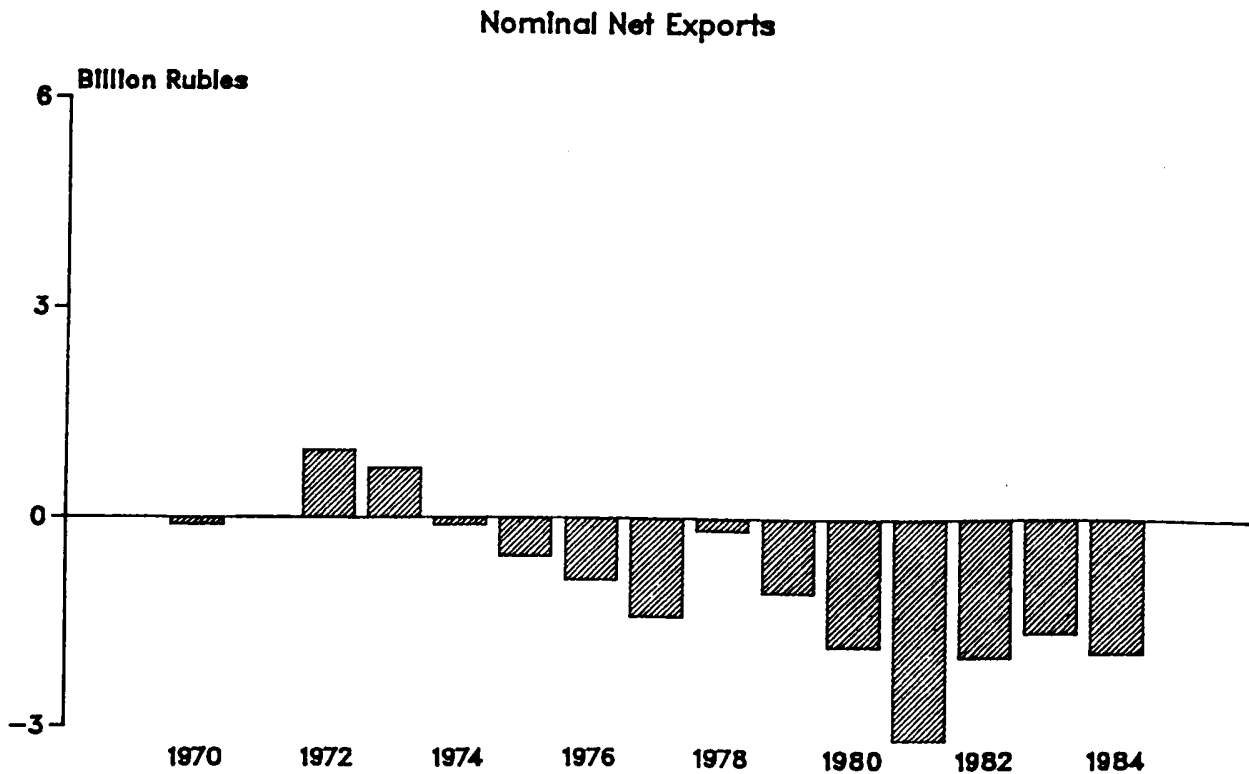
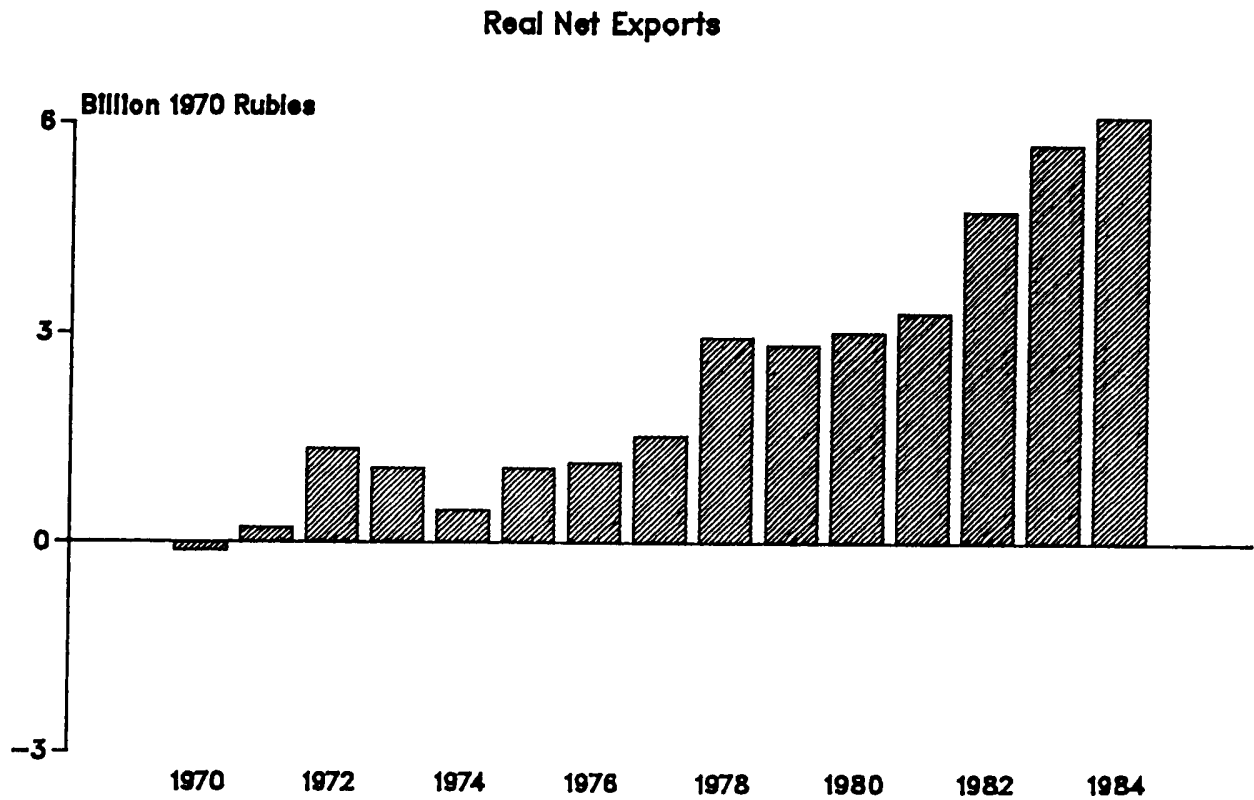
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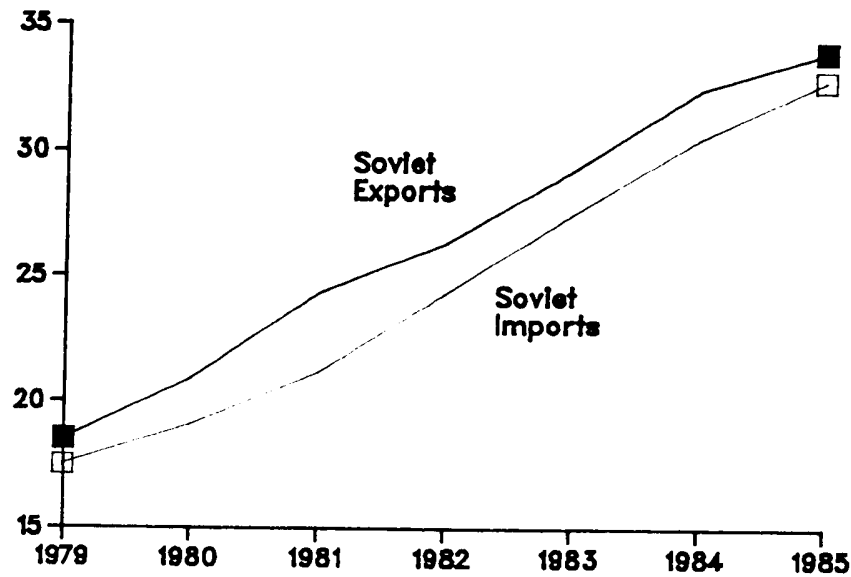
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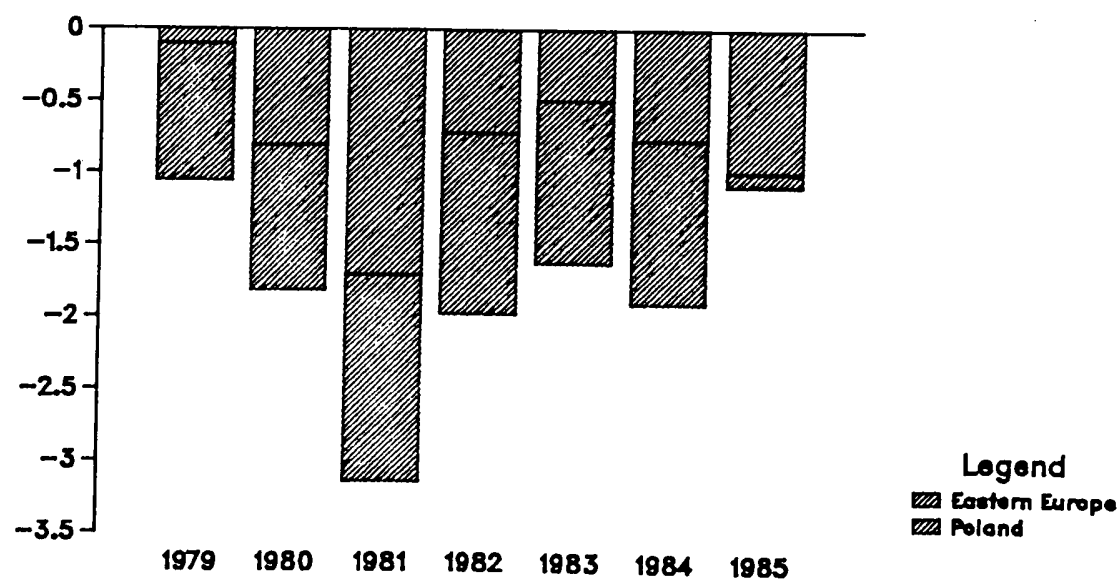
Eastern Europe: Net Exports To The USSR



Soviet – East European Trade, 1979–85
Billion Rubles



Nominal Net Exports
Billion Rubles



Moscow's Economic Demands on Eastern EuropeSoviet Goals

- Moscow sees the East European countries as important sources of machinery, technology, and consumer goods to fill gaps in the Soviet economy.
- Two-thirds of Soviet equipment imports and nearly 60 percent of Soviet consumer goods imports come from Eastern Europe.
- Some East European countries are more advanced than the USSR in certain key technologies.
- The USSR wants to scale back the level of economic support for Eastern Europe, where the standard of living is generally higher than that of Soviet citizens.
- The Soviets frequently urge the East Europeans to be less dependent on economic relations with the West, but Moscow also recognizes that for the time being the West is the only source for some goods and technology needed by all CEMA economies.
- Impatient with poor quality goods, Moscow wants the East Europeans to export their best products to the USSR rather than to the West.
- The USSR is urging the East Europeans to prepare for the day when cheap Soviet oil is no longer available by conservation by converting to natural gas and nuclear power, and by shifting toward less energy intensive industries.

Tactics: Recent Agreements

- In the past two years, the USSR has aggressively tried to inject new life into CEMA mechanisms and bilateral ties.

- In 1984, Moscow convened the first CEMA summit in fifteen years and agreed to hold them more often.
- The Soviets have concluded bilateral agreements to guide economic cooperation through the year 2000 with all of the CEMA countries except Romania, which may sign soon.
- Bilateral trade agreements for 1986-90 call for further East European efforts to meet Soviet demands.
- In December 1985, the CEMA countries approved a long-term "complex program" of S & T cooperation through the year 2000.
 - The CEMA program reflects domestic Soviet priorities and is being dominated--even more so than most CEMA activities--by the USSR.
 - The program will be the primary focus of many of CEMA's activities for many years to come.

Constraints on Moscow

- Soviet pressure on its allies is limited by the risk of unrest in Eastern Europe, which not only confronts Moscow with serious political problems, but also reduces the military and economic value of the region to the USSR.
- Soviet assistance to Poland in recent years is a good example of how Moscow tailors its economic relations to the needs and circumstances of each country.
- The East Europeans have a long history of evading Moscow's demands.
- The fall in oil prices may sharply diminish Soviet import capacity from Eastern Europe as well as from the West, but the impact will be delayed until late in the decade because of the lagged response of CEMA prices.

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USSR-Eastern Europe: New CEMA S&T Program

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The CEMA Complex Program for Scientific and Technical Progress Until the Year 2000 is a blueprint for cooperation in science and technology to spur economic growth throughout the region. Its principal goal is to close the gap vis-a-vis Western science and technology by the end of the century through greater economic integration. CEMA regards the new program as the most significant initiative since the 1971 program for cooperation and the development of socialist integration. Moscow's long-term objective is to tie East European economies more closely to the Soviet system and make them more responsive to Soviet needs. At the same time it is designed to reduce CEMA's dependence on Western technology and, in particular, to eliminate Western leverage through economic sanctions and embargoes. The twin goals of technological modernization and self-sufficiency, however, may well turn out to be inherently contradictory. This is likely to lead to serious discord among the members, which, in turn, will hamper the implementation of the program.

with them, and biotechnology. The specific goals in each of the five areas reflect the desire of the CEMA countries to be at the frontier in each field and equal to the West in the year 2000.

The program consists of 92 tasks or problems. The goal is to solve half of these problems within three years by producing new equipment and applying new technologies. To help meet this ambitious timetable, 67 new agreements are to be concluded among members and over 80 existing agreements are to be extended by June 1986.

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Three secondary multilateral accords also announced at the December meeting include an agreement on the creation and introduction of computer-aided design (CAD), another on the development and production of a unified fiber-optic information communications system, and the establishment of Interrobot. Six (unnamed) CEMA countries are slated to participate in Interrobot, which will coordinate research in advanced robots and production of robots and related components.

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Scope of the Program

The new push for scientific-technical cooperation was launched at the June 1984 CEMA Summit in Moscow, where the leaders agreed to prepare a 15- to 20-year multilateral program as the basis for a coordinated—"and in some cases, unified"—science and technology policy in CEMA. While work on the program began before General Secretary Gorbachev took office, he was probably instrumental in pushing the draft plan to completion last year. The program was originally to be completed by the end of 1984, but was not formally adopted until a special meeting of CEMA premiers in Moscow last December.

The Complex Program identifies five major areas of development: electronics, automation, nuclear power, new materials and technologies associated

Implementation: New Forms of Cooperation

CEMA's earlier effort at specialization and integration foundered largely because of an inability to provide incentives or authority to carry through on plans. As a result, CEMA's programs generally have been undermined by inattention and failure to cooperate at lower levels. The new program shows a determination to avoid repetition of these past errors; the most interesting and novel aspects are the provisions to implement it. There is a strong effort to directly involve lower levels—enterprises, research institutes, and design bureaus—and to assign them responsibility for meeting the targets.

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The Technical Targets

The announcement of the S&T program was accompanied by a list of several goals—presumably a portion of the 92 tasks. Most of the goals are described only in general terms, but the few that were specified are extremely ambitious. In addition, many of the goals have significant military applications. [redacted]

In electronics, the overall goal is the mass introduction of advanced electronics throughout CEMA. The program calls for the production of a supercomputer capable of 10 billion operations per second, which is roughly 20 times the speed of the West's fastest computer, the use of artificial intelligence to streamline management, an integrated digital information communications system, a high-speed fiber-optic communication system, and a new generation of satellite communications. [redacted]

The basic objectives in the area of new materials include cooperation to widely introduce, primarily in industry, new types of materials that are durable and resistant to corrosion, radiation, and heat. The priority tasks include the development of a ceramic internal-combustion engine and a ceramic gas turbine engine, improvement of continuous casting technology, and creation and introduction of new plastics and composite materials. [redacted]

In the area of automation, the CEMA countries want to automate their economies through widespread use of flexible manufacturing systems, computer-aided design (CAD), and computer-aided manufacture (CAM). They plan to use high-accuracy electronic sensors and measuring instruments for quality control. Industrial robots, including those with artificial vision and the ability to understand spoken commands, also are to be introduced. [redacted]

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The aims of CEMA in nuclear power development include creation of district nuclear heat and electricity supplies for civilian and industrial use (including long-distance—25 kilometer—transport of heat). Other goals include development of equipment for fast breeder reactors and multipurpose high-temperature (for increased efficiency) nuclear power engineering installations and implementation of research on controlled nuclear fusion. [redacted]

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Bioengineering tasks are directed toward medicine and agriculture and include new medicines, synthetic proteins, development of microbiological agents to protect plants against diseases and pests, bacterial fertilizers and plant hormones, and new high-yield crop varieties resistant to adverse environmental conditions. [redacted]

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A few days before the CEMA Council approved the S&T program, Moscow established 16 Inter-branch Scientific and Technical Complexes (MNTK) to coordinate Soviet research in key areas such as lasers, robotics, fiber optics, personal computers, polymers, and biotechnology. In general, each MNTK will have as its nucleus an academic or industrial ministry institute and will coordinate all of the work in its area throughout the USSR. Resources are to be ensured by the State Committee on Material and Technical Supply. Once new technologies developed by the complexes are deemed ready, the State Planning Committee will select the enterprises to apply the technologies on a broad scale. [redacted]

MNTKs are also expected to oversee the coordination and execution throughout CEMA of R&D in the five priority areas. Details are sketchy, but presumably each Soviet MNTK will work with counterpart research organizations in each of the other CEMA countries to complete the assigned tasks. Statements by CEMA officials indicate that many of the MNTKs' partners in Eastern Europe still have not been selected. [redacted]

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The leading role of the MNTKs appears to assure Soviet dominance of the CEMA S&T program and these fledgling organizations also bear great responsibility for the success of the program. The US

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Embassy in Moscow notes many uncertainties about how the MNTKs will relate to the rest of the Soviet scientific community, especially the Academy of Sciences and the State Committee for Science and Technology. []

The program stresses the importance of direct links throughout CEMA between production and research organizations at all levels. Joint Science and Production Associations, also referred to as trusts, will include both R&D institutes and production enterprises. The new multilateral Interrobot appears to be the first undertaking that encompasses both a design bureau and full production. According to the Polish press, there are proposals for additional joint enterprises in the chemical and light industries, and in agriculture. Joint scientific-research institutes, also called international collectives of scientists, will be bridges between researchers in CEMA. We do not know whether any of these have yet been established. []

Finally, bilateral coordination of economic plans—the traditional method of implementing CEMA programs—will be an important tool. In an interview, Guriy Marchuk, chairman of the Soviet State Committee on Science and Technology, pointedly said that bilateral interests of the CEMA countries will play a significant role in the Complex Program. []

Commitment of resources for the program will be the responsibility of the participating countries, although credits from the two CEMA banks, the International Investment Bank and the International Bank for Economic Cooperation, have been suggested. []

Eastern Europe's Participation

East European responses to the Complex Program, which was primarily generated by the Soviets, were guardedly positive. While the East Europeans seem genuinely interested in the benefits that would

come from fulfillment of the program, their enthusiasm is tempered by their own problems and interests:

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- Premier Stoph said *East Germany* will participate in all five areas and will develop direct ties to enterprises in other CEMA countries. Stoph reported that tasks resulting from the Complex Program are being incorporated into East Berlin's annual and five-year plans and that party and government will take the necessary short-term measures to meet commitments. He noted that industrial combines in East Germany already have responsibility for the whole production process from R&D through sales.

- *Poland* embraced the Complex Program as the answer to the technological threat from the West and Japan. Warsaw will participate in all five 25X1 areas, and expects to develop exports of drugs, mining equipment, and electronics. At the CEMA meeting, []

[] Warsaw already had increased research and development funding 30 percent above what was called for in the draft plan for R&D to 1990.

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- *Hungary* also will participate in all five major areas and 70 to 80 percent of the tasks of the program. In electronics, Budapest will participate in the development of two new central processor computer units and new software. In bioengineering, their contribution will be in agro-industry and pharmaceuticals. []

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- Statements by *Czechoslovak* Premier Strougal indicated that Prague wishes to participate across the board in the Complex Program, and will be

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active in 50 to 75 percent of the programs. He emphasized that participating countries must fulfill their commitments.

- **Bulgaria** is likely to have a major—but not dominant—role in robotics. [redacted] many countries are vying for leading roles in the CEMA robotics program.
- The **Romanian** response was cooler than that of the other CEMA countries. [redacted] in December, President Ceausescu complained that plan coordination for 1986-90 did not meet the goals of the 1984 CEMA Summit and that CEMA had failed to establish production specialization and production coordination. He later asserted that CEMA had failed to meet the commitments to solve the energy and raw materials problems, and stated that Bucharest will focus its resources on these problems before it addresses such topics as robotics. [redacted]

advanced countries—Hungary and East Germany, for example—will have less to gain from sharing their technology and may be reluctant to contribute. The success of the program will depend largely on the willingness of scientists and engineers in each country to share their knowledge and techniques with the rest of CEMA. [redacted]

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Nonetheless, this initiative may yield better results. The emphasis on implementation indicates the Soviets have correctly diagnosed some of the flaws in earlier programs, although only time will tell whether the new organizations and mechanisms will be the appropriate remedy. It is also possible that the East Europeans will be more willing and active participants than in the past. The prospect of technological advance appeals to them, and trade with the West probably is no longer considered by some as the path to prosperity. Finally, in Gorbachev the East Europeans face for the first time in many years a tough and vigorous Soviet leader who clearly expects his allies to toe the line—and who has put his own stamp on CEMA's new initiative.

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Outlook: Old Obstacles and New Conditions

History offers much reason for skepticism about the success of the latest Soviet-inspired drive for integration of the Bloc economies. Past efforts, launched with similar vigor and rhetoric, have achieved, at best, mixed results. Earlier programs succumbed to the ability of some of the East Europeans—and perhaps the Soviets—to duck their commitments in favor of pursuing trade with the West and other economic and political goals. The programs lacked the institutional authority to compel participation and the incentives to encourage it. [redacted]

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The East European countries still may present several obstacles to the new program. They will be strapped to commit large amounts of resources to CEMA S&T because of prospects for slow economic growth, debts to the West, and large investments in Soviet energy projects. The more technologically

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Soviet-East European Trade Plans for 1986-90

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Plans call for trade between the Soviet Union and Eastern Europe to grow more slowly in the next five years than at any time since the 1960s. Rapid increases in East European exports in recent years have resulted in roughly balanced trade with the USSR, and we expect both the value and volume of those exports to grow much more slowly. Soviet pressure is likely to focus on improving the quality of East European exports and forcing the East European regimes to make tough choices about exporting to the West and supplying domestic needs. Moscow's ability to export to Eastern Europe will be limited by declining oil production and a hard currency squeeze. A key unknown is whether Moscow will meet its commitment to maintain oil deliveries during the next five years. Major cuts in oil exports could well disrupt East European economies and dramatically alter Moscow's economic relations with Eastern Europe.

Review of Recent Trade Trends

Beginning in the mid-1970s, the USSR permitted its East European partners to run large trade deficits in recognition of their inability to generate enough exports to cover the rising cost of Soviet oil deliveries. The imbalance grew even larger in the early 1980s as the Soviets extended trade assistance to Poland during its economic crisis. In recent years, Moscow has become less willing to support Eastern Europe. In part, Moscow may have become impatient with the East Europeans' inability to close the trade gap. Moreover, the Soviets found themselves having to accept poor-quality East European goods in exchange for Soviet oil and raw materials that were becoming increasingly costly to produce. Moscow's push for more balance narrowed the annual trade deficits from a high of 3.1 billion rubles in 1981 to 1.9 billion rubles in 1984, and may have nearly eliminated them in 1985 for all countries except Poland. Soviet trade data show the region running a 900 million ruble deficit with the USSR through three-quarters of last year. The deficit resulted in large part from Poland's trade gap; Soviet trade with the rest of the region was nearly balanced.

Over the past decade the Soviets enjoyed a sharp improvement in their terms of trade with the East Europeans because energy prices were rising faster than other prices in intra-CEMA trade. In *value* terms, Soviet exports to and imports from Eastern Europe more than doubled from 1978 to 1985. But according to our estimates, the *volume* of Soviet deliveries to Eastern Europe rose by less than 10 percent over the entire period, while real import volumes from the region increased by nearly 50 percent.¹ Thus, even though Moscow's tolerance of East European trade deficits softened the blow from the higher energy prices, the Soviet gains in terms of trade resulted in sharply increased East European exports in exchange for the same quantity of Soviet goods (see figures 1 and 2).

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1986-90 Trade Plans: Slower Growth

Protocols concluded in the final months of 1985 between the USSR and its East European allies on the coordination of national economic plans provide the framework for bilateral trade through 1990.² Over the past decade protocols, while underestimating the value of actual trade because of unexpectedly rapid price increases, have been relatively good indicators of the types and quantities of traded goods.

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The 1986-90 protocols call for trade to total 380 billion rubles over the period. This target implies an average annual growth rate in the value of Soviet-East European trade of only 5 percent—the slowest

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¹ Estimates are based on the use of Hungarian ruble price indexes as price deflators of official Soviet foreign trade statistics. Soviet and Polish indexes for prices and trade volumes show similar trends but are not as comprehensive as the Hungarian data.

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² Protocols on plan coordination are forerunners of Trade and Payment Agreements, which appear to be more precise and binding. Press reports on the Trade and Payment Agreements signed by the Soviets and the East Europeans provide few additional details, but they appear to be consistent with the plan coordination protocols.

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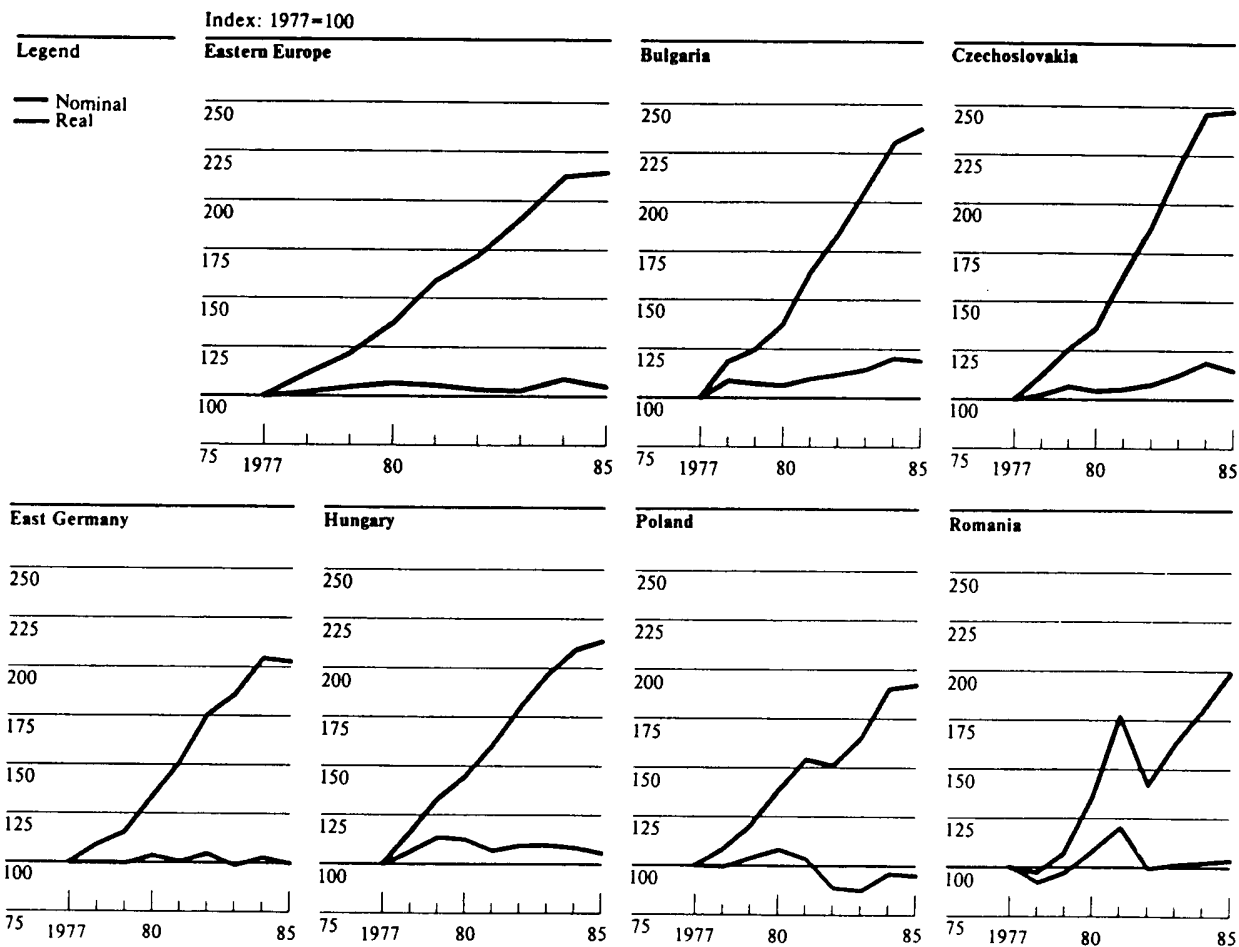
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Figure 1
Index of Soviet Exports to Eastern Europe, 1977-85*



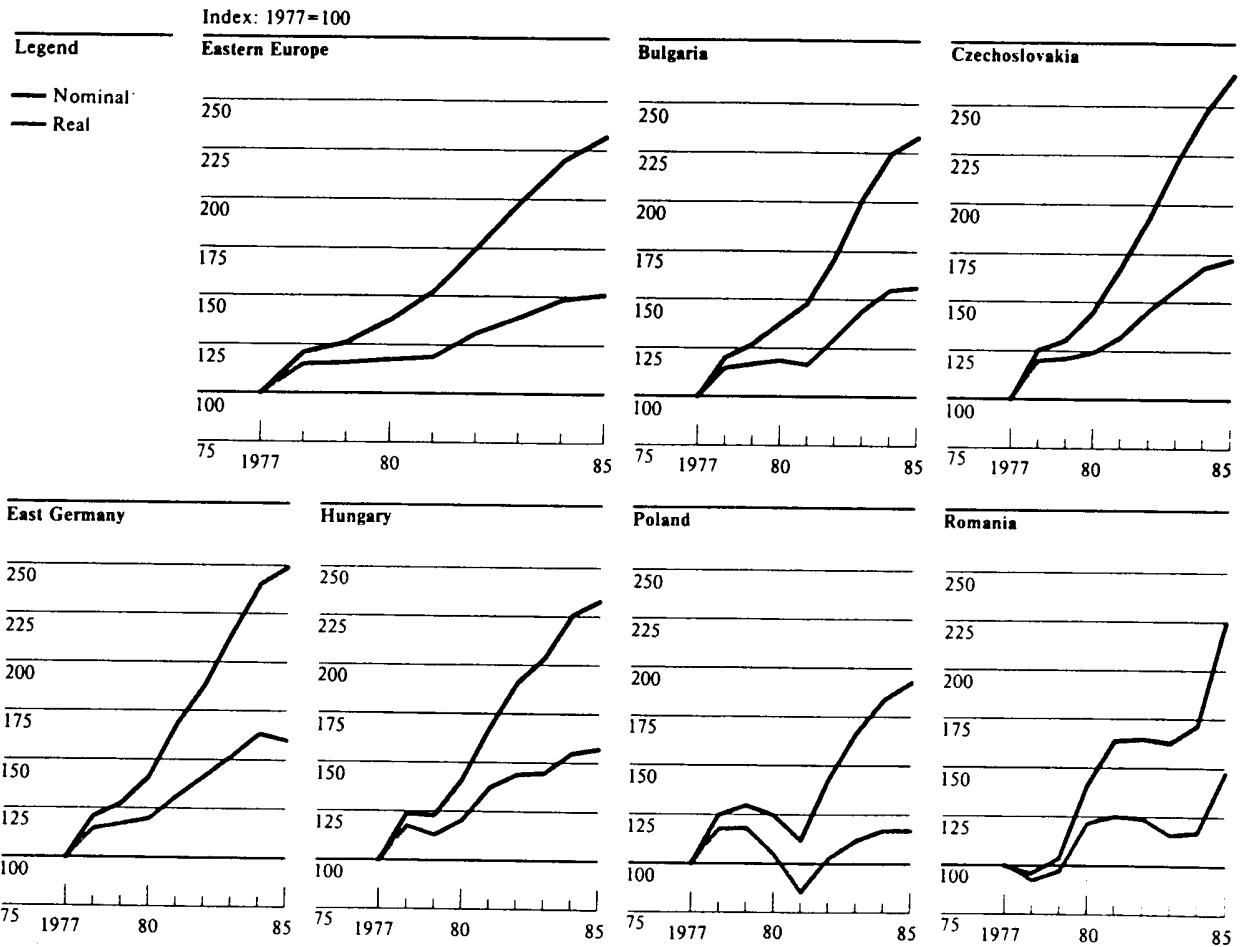
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Figure 2
Index of Soviet Imports From Eastern Europe, 1977-85*



* Data for 1985 are estimated on the basis of third-quarter Soviet and Hungarian statistics.

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Soviet-East European Trade Plans

	Five-Year Trade Turnover ^a (billion rubles)		Increase ^b (percent) 1986-90/ 1981-85	Average Annual Increase ^c (percent) 1986-90	Date Protocol Signed
	1981-85	1986-90			
Total	280	380	36	5	
Bulgaria	52	70	35	5	20 December 1985
Czechoslovakia	55	73	33	4	29 October 1985
East Germany	66	82	24	3	31 October 1985
Hungary	40	51	28	5	28 November 1985
Poland	50	74	48	8	7 October 1985
Romania	17	30	76	12 to 15	14 December 1985

^a Trade in 1985 estimated on the basis of six-month Soviet trade statistics and annual protocols.

^b These rates, based on CIA estimates, differ somewhat from several East European announcements for turnover growth with the USSR: 28 percent for East Germany; "approximately 40 percent" for Bulgaria; and "more than 30 percent" for Hungary.

^c Calculated using estimates of trade in 1985 as base year.

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growth in planned trade in the past 15 years.³ Because a portion of this growth apparently is attributable to price increases, we believe that the rise in the volume of goods traded will be slight. The modest targets in the protocols belie the oft-discussed need to increase trade and cooperation within CEMA, as well as statements by officials in some East European countries who say that trade will be diverted away from the West toward the USSR (see table). []

The plans contrast sharply with the 11-percent annual growth in the value of trade in the 1978-85 period, which resulted from the spiraling costs of Soviet oil and increases in the volume of East European exports to close the trade gap with Moscow. The slowdown in trade projected through 1990 reflects, in part, planners' expectations of slower price increases than in the early 1980s. It also reflects the difficulty Moscow—which benefited from windfall gains on its oil exports

³ The percentages announced compare the value of trade planned for 1986-90 with the value over the entire 1981-85 period. As a result, the announced growth is greater than if it were taken from a base of 1985 trade. We believe 1985 is the proper base from which to project trade. []

in the past—faces in generating the additional exports required for continued growth in Soviet-East European trade. []

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Inflation in intra-CEMA trade should be reduced substantially as the stability of Western prices in the past few years becomes incorporated into CEMA prices. According to the CEMA pricing mechanism, which is based on the average of world market prices during the previous five years, Soviet oil prices to Eastern Europe will decrease slightly in 1986 and will fall slowly in following years.⁴ The prices of East European exports—composed primarily of machinery and manufactured goods—are more difficult to predict, but should rise slightly because they are tied to prices of Western machinery. They may also rise as a

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⁴ The CEMA Executive Committee announced in January 1985 that the price formula in use since 1976 would be continued for trade in the 1986-90 period. []

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result of the increased costs of producing the quality machinery Moscow demands. With energy prices falling and at least some price increases likely for East European exports, Moscow faces a deterioration in its terms of trade for the next several years. Any effort by the Soviets to overcome this deterioration—by changing the pricing formula in their favor or through item-by-item negotiation—would meet with strong East European resistance. []

Emerging Trade Patterns

The protocols generally omit figures on the key question of how total trade will be divided between Soviet exports to and imports from Eastern Europe, but several factors suggest that East European surpluses are likely, reversing the trade imbalances of the past decade:

- Eastern Europe's base of trade in 1985 was roughly in balance (except for that of Poland), according to our projections based on preliminary trade data.
- Price trends probably will favor East European exports and move against Soviet fuel exports.
- Moscow's oil deliveries will be at best constant and could well decline.
- The Soviet leadership clearly feels that its allies should repay the debt accumulated during the 1970s and early 1980s.
- The protocol for Poland—the country in the weakest position to meet Moscow's demands—calls for trade to be balanced over the next five years, and the Soviets may feel that the other countries could do even better. []

Soviet demands for more East European exports reinforce the indications in the protocols that much of the growth in trade for the rest of the decade will come from Eastern Europe. Eastern Europe conceivably could run surpluses large enough to repay the entire 15 billion rubles owed by increasing exports, in nominal terms, by 7 percent annually and holding import growth to 4 percent. []

Although the protocols imply relatively modest increases in the *quantity* of exports, nearly all of the protocols, as well as other bilateral and CEMA agreements on long-term science and technology cooperation, emphasize that the East Europeans must improve the *quality* of their exports. Meeting Soviet demands, in turn, may cut into their ability to earn foreign exchange—their best goods are normally sold in hard currency markets—and satisfy domestic needs. Implied Soviet threats to cut energy and raw material deliveries if the requisite quantity and quality of goods are not forthcoming from Eastern Europe are a potent lever in ensuring compliance. Moscow's demands for better machinery, food, and other consumer goods, however, will be tempered by Eastern Europe's ability to maintain domestic economic growth and remain financially solvent in dealings with the West. Moreover, Moscow may still be willing to grant concessions if an East European country's economic problems become serious enough to warrant them. []

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We expect the major constraint on trade in 1986-90 to be Moscow's inability to boost exports to Eastern Europe. Little growth can be expected in deliveries of oil and other fuels—the mainstay of the USSR's exports. Moscow will maintain oil deliveries at 1985 levels of about 70 million tons, according to statements by Soviet and East European officials. While the Soviets stand ready to increase oil deliveries to Romania, and possibly other countries, in exchange for dollars or for goods that could be sold for dollars, the East Europeans probably cannot afford major purchases on these terms. []

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Gas deliveries will not grow substantially until 1989 when the Yamburg pipeline comes on line. All countries will invest machinery, equipment, or manpower in this project in exchange for a share of 20-22 billion cubic meters of gas annually over 20 years. East European participation in other joint projects, such as the Krivoy Rog iron ore complex, probably will lead to only moderate increases in some raw material deliveries. []

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Agreements by Country

While the protocols have in common generally level Soviet supplies of raw materials and continuing pressure on Eastern Europe to deliver more and better goods to the USSR, there are important differences among the agreements signed with each country (see inset). The highest rates of growth in trade are projected for those countries with economies in the most trouble—Romania and Poland. East Germany and Czechoslovakia are in much stronger economic positions, but their protocols call for much more modest trade growth. Yet these countries will probably face the strongest demands to improve the quality of their exports. [redacted]

The agreement to increase *Romania's* trade with the USSR by over 70 percent—the highest rate in Eastern Europe—reflects Bucharest's desperate efforts to secure aid for its ailing economy. Bilateral trade, however, will be limited by Romania's ability to meet export commitments. Imports of Soviet crude oil increased in 1985 to about 2 million tons, but for the second year in a row Romania received little more than half of the oil it had contracted for because of its inability to provide the meat, other foodstuffs, and industrial machinery demanded by Moscow. [redacted]

Poland seeks to regain the place of second-largest Soviet trading partner among CEMA countries, which it lost after Warsaw's inability to meet export commitments in 1980-81 led to a decline in trade.³

[redacted] the 1986-90 period will focus on the development of both economies—in contrast to 1983-85, when the Soviets extended substantial economic assistance to help Warsaw recover from its economic crisis. While Moscow will allow Warsaw to run trade deficits through 1987, the protocol calls for Poland to run surpluses in 1989 and 1990 large enough to balance trade for the five-year period as a whole. Repayment of 5 billion rubles owed to the Soviets will be deferred until after 1990. [redacted]

[redacted] Moscow's negotiations on 1986-90 trade with *East Germany*—its largest trading partner—were difficult and long delayed

³ Poland's economic situation was so unsettled in 1980-81 that Warsaw and Moscow did not even conclude a trade agreement for 1981-85. [redacted]

[redacted] Perhaps to gain leverage in holding Moscow to its commitments, the East German announcement of the protocol prominently specified planned amounts of several fuel and raw material imports from the USSR. [redacted]

Czechoslovakia will contribute equipment and 12,000 workers for the construction of the Yamburg gas pipeline and a gas treatment plant in the USSR in exchange for 5 billion cubic meters of gas annually over 20 years. Czechoslovak officials have said publicly that Soviet oil and raw material deliveries will continue at 1985 levels through the next five years, [redacted]

[redacted] *Hungary* has convinced Moscow to continue purchasing its meat surplus for hard currency by arguing that the planned elimination of such transactions by the Soviets would threaten Hungary's fragile hard currency position. [redacted]

Bulgaria's relationship with Moscow over the past year has been strained. Soviet displeasure over Bulgaria's economic policies and the Slavicization campaign against the Turkish minority in the country probably is the major reason Moscow cut back on crude oil deliveries to Bulgaria last year. [redacted]

Oil: The Key Unknown

Although we believe that the trade plans announced in the protocols—often the products of tough negotiations—genuinely reflect intentions, future events and developments could force the plans to be modified or, more likely, could cause results to diverge from goals. The largest uncertainties are in Soviet oil exports. Although Moscow for the most part has so far insulated Eastern Europe from cuts in oil exports, it

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Protocol Highlights

	<i>Soviet Exports</i>	<i>East European Exports</i>
<i>Bulgaria</i>	<i>Machinery and equipment for reconstruction of metallurgical, chemical, machine-building industries. Continuation of energy deliveries at 1985 levels.</i>	<i>Increases in machine-building, electronic, electrical-engineering products. More consumer goods, fruits, vegetables.</i>
<i>Czechoslovakia</i>	<i>50-percent increase in machinery. Equipment for power, metallurgical, chemical industries and for Prague subway. Maintenance of oil and raw materials at 1985 levels.</i>	<i>"Substantial" increase in consumer goods. Equipment and 12,000 workers for construction of Yamburg pipeline and gas treatment plant at Karachaganak.</i>
<i>East Germany</i>	<i>Annual deliveries of 17.1 million tons of oil, 6.9 billion cubic meters of gas, 4.5 million tons of coal, 1.7 million tons of iron ore, 3.2 million tons of rolled steel.</i>	<i>40-percent increase in consumer goods and 50 percent in chemicals. Doubling of electrical engineering and computer-related products.</i>
<i>Hungary</i>	<i>15-percent increase in gas this year, probably in exchange for food and agricultural products. Additional 2 billion cubic meters of gas from Yamburg beginning in 1989.</i>	<i>Increase in oil and gas equipment. Equipment for reconstruction of Soviet chemical, agricultural machinery, light industries.</i>
<i>Poland</i>	<i>Maintenance of oil deliveries at 15 million tons annually. Additional 1 billion cubic meters of gas this year through Kobrin-Brest pipeline, plus another 5 billion cubic meters from Yamburg beginning in 1989.</i>	<i>"Large" deliveries of ships, heavy machinery, lathes, electric motors, textile and chemical industry equipment, roadbuilding and agricultural machinery. Increases in food and agricultural products.</i>
<i>Romania</i>	<i>2-3 million tons of oil annually. Increases in gas and iron ore.</i>	<i>Doubling of machinery deliveries to 6.5 billion rubles. 1-1.5 billion rubles in ships, equipment for oil drilling and exploration. 500 million rubles in agricultural machinery. Metallurgical equipment worth 1 billion rubles. Increase in consumer goods and chemicals.</i>

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may find it increasingly difficult to do so if oil production and prices continue to fall. With hard currency shortages of its own, Eastern Europe would be hard pressed to replace any Soviet deliveries diverted to the West. The region already faces tight energy supplies as evidenced by severe shortages in several countries during the past year. Even modest cuts in oil deliveries could seriously undermine the economic performance of several countries.

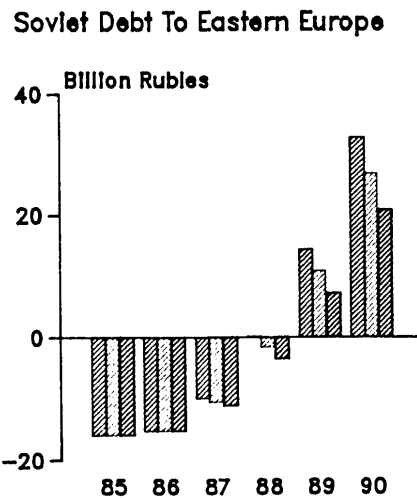
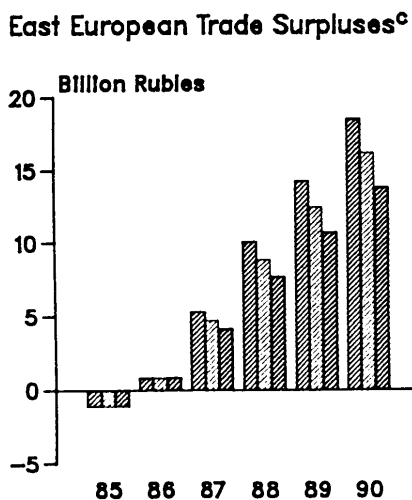
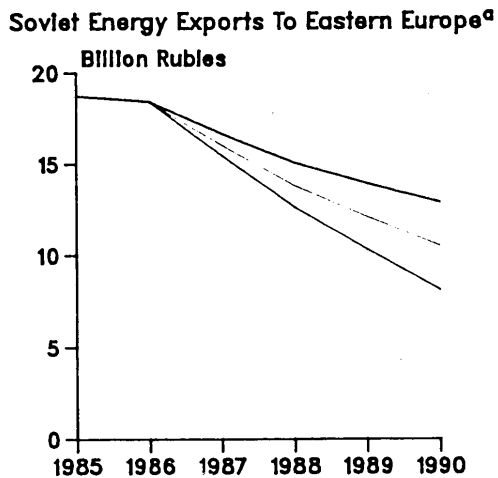
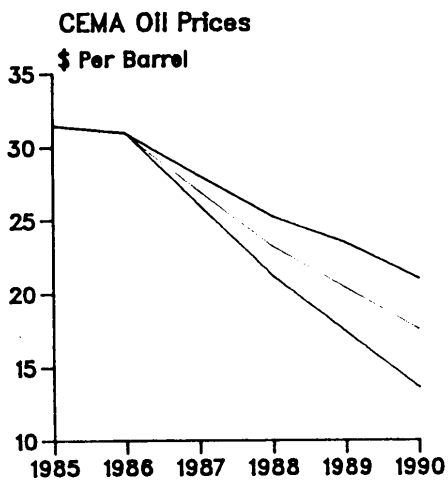
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Moreover, if Moscow chose to make the cuts large and abrupt, it would risk the entire structure of its economic relationship with Eastern Europe. The USSR has little to offer besides oil, especially in the short run, and the East Europeans would be forced to divert their trade to the West or to the Middle East to obtain oil.

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Legend

\$10/Barrel OPEC Oil 1986-90
\$15/Barrel OPEC Oil 1986-90
\$20/Barrel OPEC Oil 1986-90

- ^a Assumes the volume of fuels --oil, gas, coal, electricity-- remains unchanged and prices of various fuels move together
- ^b Assumes 5 percent growth in Soviet non-energy exports
- ^c Assumes 7 percent annual growth in East European exports

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1 - [redacted] (author)

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